Pacific has been willing to accept in competitive markets. This margin would be reflected in toll and Centrex contracts entered into by Pacific.

CCTA also notes that if the Commission includes shared and common costs in the universal service fund, it must account for the same amount in the OANAD proceeding. CCTA contends that the failure to include the same amount of shared and common costs in the price floors for services could allow the LECs to price anticompetitively.

DRA argues that the recovery of shared and common costs is a pricing issue. Instead of including these costs in the subsidy calculation, DRA recommends that the Commission allow incumbent LECs to make their own pricing decisions regarding the amount of shared and common costs that should be recovered from residential basic service. DRA recommends that this recovery should be determined in the OANAD proceeding.

If, however, the Commission wants to determine the appropriate amount of shared and common costs, then DRA proposes that the Commission use Pacific's PI model, and the allocation factors and results derived in that model, that was submitted by Pacific for use in the OANAD proceeding. DRA contends that because residential basic services are relatively inelastic, the Commission should limit the amount of shared and common costs that can be recovered by the incumbent LECs through their basic service rates until the market is fully competitive.

In OANAD, Pacific submitted an account by account analysis, and allocated shared and common costs into sixteen family buckets. The allocation was based on the allocation factors developed in the PI model. When the CPM was updated prior to the hearings in this proceeding, Pacific used modified PI allocation factors for two of the sixteen family buckets. The first bucket is labeled "Business-Residential-Public", while the second bucket is made up of "Residence 1" and "Residence 2." DRA points out that this deviation resulted in assigning the costs of the two family buckets to services in those two families. This increased the shared costs allocated to basic service by 85%. DRA believes that it was unreasonable for Pacific to simply pick two of the buckets and reallocate their cost to services within the family, without applying the same process to the remaining fourteen cost families. DRA recommends that the Commission reject the modified PI allocation factors that Pacific made. Instead, DRA believes that the allocation of costs used in OANAD, using the unmodified PI model, is reasonable and sufficiently reliable.

DRA also recommends that the Commission use Yellow Page revenues to offset the LECs' shared and common costs.

GTEC argues that markups for shared and common costs are appropriate for basic service. GTEC states that in competitive markets, multi-product firms have to obtain contributions to shared production costs and overheads from wherever they are available. The amount of contribution placed on each product depends on the demand elasticity for the product and supply conditions. GTEC describes the Ramsey pricing rule, which details the equilibrium prices in a competitive market. Under the Ramsey pricing rule, services which are less demand elastic will contribute a larger amount to shared and common costs.

ICG agrees with AT&T/MCI and TURN's view that only the shared cost of the local loop should be recoverable in the fund.

Roseville and the Smaller Independent LECs argue that if they are included in the funding mechanism, the Commission must also allow the COLR to recover its shared and common costs.

TURN agrees with Cornell's testimony that the loop is the only shared cost which should be included in the subsidy calculation, and that Pacific should recover all other shared and common costs from other services. In his testimony, TURN witness Long cites from the Telco Act that, "services should bear no more than a reasonable share of joint and common costs." He goes on to explain that the conference report of the Telco Act states that universal services may bear less than a reasonable share of their joint and common costs.

TURN also contends, based on the allocations of shared and common costs that it has reviewed, that Pacific has vastly overstated the amount that should be treated as the cost of basic residential service. TURN argues that including such costs will significantly increase the number of lines eligible for support from the fund, and for each such line, increase the amount of support.

TURN asserts that Pacific did not meet its burden of proof in showing that these shared and common costs should be attributable to universal service, and that the Commission should not include any of Pacific's shared and common costs in the cost of basic residential service.

Pacific argues that inclusion of a reasonable amount of shared and common costs is both consistent with the Telco Act and necessary for the market to function. They state that the biggest shared costs involve number administration, network test centers and network control centers. Pacific argues that the shared and common expenses to be recovered are those for the universal service cost object. The costs affected include billing of residential customers, receiving and answering inquiries from residential customers, and developing methods and procedures for installing and maintaining service to residential customers. Pacific witness Emmerson testified that the loop is not a shared cost. He also states that the universal service fund must make a reasonable contribution to a carrier of last resort's shared and common costs.

b. <u>Discussion</u>

We first address the issue of whether the loop is a shared cost of universal service.

AT&T/MCI, and TURN argue that the local loop meets the definition of a shared cost, as defined in the CCPs. TURN also cites the decisions of other public utility commissions wherein this issue was discussed.

This Commission previously touched upon this subject in the Implementation Rate Design (IRD) decision, D.94-09-065. In that proceeding, GTEC and Pacific had argued that the loop was built in response to the end user's subscription to basic telephone service. Therefore, the expense of the line and switch is incurred regardless of whether the facilities are ever used. Thus, much of the loop plant is characterized as nontraffic sensitive (NTS). TURN had argued that the NTS plant costs were actually "joint and common costs" needed to operate the network and to provide both incoming and outgoing local and toll calls. The Commission agreed with the contentions of Pacific and GTEC that the NTS costs should be assigned to basic exchange services. The Commission also recognized that the loop cost for interstate uses of the network received a contribution from the EUCL charge. (D.94-09-065, pp. 43-44.)

Given our previous determination in D.94-09-065, we decline to conclude in this proceeding that the loop is a shared cost, and that only the shared cost of the local loop facility that is not currently recovered in rates should be recoverable from the CHCF-B. However, we believe that Section 254(k) of the Telco Act places a limit on the share of joint and common costs of facilities that should be borne by the service elements that make up basic service. In order to determine what that limit should be, we focus our attention on how the shared and common costs were allocated in the CPM.

Several of the witnesses testified to the difficulty of allocating shared and common costs, and some of them referred to such attempts as arbitrary.[43] There were several examples during the hearing of how costs were arbitrarily assigned to basic service. For example, an advertising promotion that was designed to promote the sales of extra telephone lines to existing customers would be attributable 100% to basic service. (26 RT 3617-3618.) The cost of billing residential customers would be assigned to basic service as well. (26 RT 3614-3615.)

Another example of how costs are allocated somewhat arbitrarily are the costs associated with billing inquiries to residence service centers. These shared billing inquiry costs are in addition to the billing inquiry costs the CPM directly identifies as being associated with basic service. These costs also do not include the incremental service related costs associated with ULTS.

According to Pacific, these billing inquiries have to do with residential customers not being able to pay current bills and negotiating payments. The CPM allocates 100% of these costs to basic service. However, as TURN's witness Long points out, the cause of the inability to pay or to negotiate a payment schedule may be due to items that appear on the customer's bill other than residential basic service. That is, the inability to pay is likely more attributable to toll calls, services billed by Pacific for interexchange carriers or information service providers, or for custom calling features. (Ex. 121, pp. 8-9.) Pacific witness Scholl acknowledged that Pacific has not done any study to determine whether customers who request special payment plans do so because of the customer's inability to pay the basic exchange service charge as opposed to any other charge. (24 RT 3132-3133.)

43 This arbitrary allocation problem was also noted in the IRD decision in D.94-09-065 at page 44.

TURN also points to another category of costs that have been allocated 100% to basic service. These costs involve customer inquiries to customer representatives regarding multiple products, and obtaining service turn on dates. In addition, this category of costs includes such things as the customer representative stating "hello, thank you for calling Pacific Bell," and for training, meetings, and waiting to serve. As TURN points out, none of these activities appear to be specifically caused by residential basic service, as opposed to any other residential service offering of Pacific.

TURN also provides other examples of how Pacific's allocation of shared and common costs in the CPM in the Residence 2 family bucket, and the family bucket labeled "Business, Residence, Public", have resulted in unreasonable and arbitrary allocations. Although 90% of the Residence 2 bucket was allocated to basic service, TURN contends that Pacific has not justified why basic service has been allocated that percentage of the shared and common costs. With respect to the Business, Residence, Public family bucket, TURN points out that prior to Pacific's revision of its cost model, Pacific had only allocated 16% of the shared costs to residential basic service. The CPM now allocates 81% of those shared costs to that family bucket. TURN witness Long suggests that Pacific should be held to its initial lower initial estimates.

We agree with TURN that Pacific has not demonstrated that the costs described above, and allocated by the CPM to basic service, were caused by residential basic service, as opposed to the many other services offered by Pacific. In addition, the modification of only two of the sixteen allocation factors calls into question the reliability and reasonableness of those allocators. Pacific's own witness testified that only two of the sixteen family buckets had the allocation factors changed. The other fourteen buckets remained the same. In addition, we must keep in mind in reviewing these costs that the PI model is based on direct embedded costs, and is not a TSLRIC model.

As mentioned above, we believe that the Telco Act mandates that a reasonable portion of the shared and common costs should be included as part of the cost of basic service. Clearly, some amount of the shared and common costs are attributable to residential basic service. However, the modified PI allocation factors that Pacific used for two of the family buckets for use in the CPM, result in a shifting, or loading up of costs onto basic service. As a result, basic service bears more than its reasonable share of the joint and common costs under the CPM.

We have analyzed the unmodified PI allocation factors that Pacific used initially for the proprietary version of the CPM. We believe that those allocation factors result in more reliable and reasonable allocations of shared costs than those proposed by Pacific. We will use those shared allocation factors for the CPM.

As TURN points out, the Conference Report regarding the Telco Act contemplates that the cost of universal service may bear less than a reasonable share of joint and common costs. The reasoning for that provision is to prevent cross subsidy and anticompetitive behavior. Consistent with that direction, we will reduce the common costs per line to $2.00 to safeguard against these possible problems.

As a result of these adjustments, the annual subsidy will be reduced by an additional $415.7 million.

12. Rearrangement Expenses And The Nonrecurring Burden

a. Background

In the CPM, Pacific includes expenses for the rearrangement of plant, and an item called the nonrecurring burden. These two cost items add up to $268 million.

The rearrangement expenses are the costs associated with rearranging existing facilities to accommodate new and existing customer demand. Some examples of rearrangement expense include rewiring equipment to reflect changing calling patterns, moving existing customer lines from old equipment to new equipment, and rewiring or modifying equipment so additional new equipment and new customers can be added to the network.

The nonrecurring burden expense covers the expenses which a LEC incurs by installing and disconnecting residential telephone lines which the LEC does not recover in its nonrecurring charge.

Parties debated whether rearrangement expenses should be included in the subsidy calculation. AT&T/MCI state that the CPM overstates the costs of basic service because of rearrangement expenses. AT&T/MCI witness Selwyn recommends that rearrangement expenses be eliminated because there will be very little churning of facilities as a result of the Commission's quick dialtone requirement. Selwyn views rearrangement expenses as "the labor costs associated with the reuse of existing loop facilities made available as a result of customer churn." (Ex. 7, p. 88.)

DRA contends that the CPM is supposed to estimate the cost of basic service using forward looking technology for the entire quantity of the service. DRA believes that the CPM should therefore include rearrangement expenses that are associated with serving the entire quantity of the service, and not those associated with just serving new customers.

Pacific responds that rearrangement costs are properly included in the CPM calculation, and that the elimination of these expenses will understate the costs of providing universal service. Pacific witness Scholl stated that rearrangement expenses involve many more activities than just dealing with existing customer churn. Such expenses are not just for loop facilities, but are also incurred for switching, interoffice facilities, and other investments. Scholl states that these rearrangement expenses are part of the costs of having investment in place to service new customers.

Scholl also states that AT&T/MCI witness Selwyn is wrong in his interpretation of what costs are included in rearrangement expenses. As a result, Selwyn wrongly concludes that rearrangement expenses will go away with the Commission's requirement for quick dialtone. Instead, as economic circumstances change, and the population grows, there will be a continual need to rearrange existing equipment.

With respect to the inclusion of the nonrecurring burden in the universal service subsidy, AT&T/MCI witness Selwyn argues that with quick dialtone, the nonrecurring burden should be minimal as well.

DRA argues that the nonrecurring burden should be treated as a shared cost. As a shared cost, DRA recommends that the LECs should be allowed to determine recovery of the expense.

Pacific states that LECs incur the nonrecurring burden expense because rates for installation have been kept below cost.

b. <u>Discussion</u>

We are somewhat persuaded by AT&T/MCI's argument that rearrangement expenses should be minimal as a result of PU Code § 2883 requiring continuing access to 911. As a result of that requirement, a large percentage of existing lines are going to remain in place, and rearrangements of wire should be kept to a minimum. Rearrangements will primarily be caused by demand for second and additional lines. However, we agree with Pacific that one cannot ignore future growth, and that there are still likely to be situations where moving, modifying or making changes to facilities will be necessary in order to accommodate demand.

Since the target of the universal service subsidy are primary access lines, we will deduct 75% from Pacific's estimate of its rearrangement expenses. This reduction results in a $165.9 million annual subsidy decrease.

Regarding the issue of the nonrecurring burden, our same analysis of rearrangement expenses apply. When a new customer requires service, turn up of that service will be at the central office. Since the primary lines are already in place providing 911 access, it will be a rare occasion when the carrier will have to go out to the customer's premise. We will also deduct 75% from Pacific Bell's nonrecurring burden estimate. This reduction results in a $41.6 million annual subsidy decrease.

13. Directory Assistance

a. Background

DRA recommended in its opening testimony that if the CPM was to be adopted, relevant cost data from Pacific's and GTEC's OANAD cost studies should be included. DRA noted in its opening testimony that a comparison of the CPM's estimates of GTEC's costs in OANAD to the costs shown in the CPM showed a significant difference. (Ex. 109 or Ex. 110, pp. 3-16 to 3-17, Table 3.2.)

b. Discussion

The Telecommunications Division staff responsible for analyzing the workings of the CPM results questioned the directory assistance cost reflected in the CPM after reviewing Table 3.2. The Telecommunications Division sent a data request to Pacific in June 1996 requesting the monthly volume of directory assistance calls. The reported volume of calls was compared to the volume and cost per call contained in the CPM, and to GTEC's OANAD cost of providing directory assistance. The staff determined that the CPM cost estimate for directory assistance was overstated. We will adopt the staff's adjustment of the cost of directory assistance. This change results in an annual adjustment of $48.4 million.

G. Benchmark

1. Introduction

This issue addresses the cut-off point, or benchmark, at which we determine whether a GSA is high cost or low cost. That is, the benchmark serves as the guide for determining which GSAs have "affordable" service, and which GSAs have higher costs, or less affordable service. (See AB 3643, Stats. 1994, Ch. 278, Sec. 2(b)(1).) The benchmark is an important issue because it serves to size the fund by limiting subsidy support only to those GSAs in which the proxy costs of serving that area exceed the benchmark.

Establishing a benchmark also has implications for future rate design. If the benchmark is set at a level above the current basic local exchange service rate in a particular GSA, that may cause pressure to increase the rate toward the benchmark to more closely reflect the cost of providing service to that GSA.

D.95-07-050 proposed that the GSA should be considered high cost if the proxy cost of serving that GSA was above the revenues generated by the LEC offering basic service in that particular GSA.

2. Positions of the Parties

AT&T Wireless commented that if the high cost GSA was designated as suggested by the proposed rule, that such a rule will make the high cost fund overly dependent on each LEC's revenue requirement. This could lead to a situation where customers in two different GSAs with identical proxy GSA costs, are treated differently for purposes of CHCF support.

AT&T Wireless recommends that the benchmark should be the statewide average proxy costs of all GSAs. If the proxy cost of serving a particular GSA exceeds the statewide weighted average of serving all GSAs, then the GSA would be considered high cost. The subsidy would then equal the difference between the specific proxy cost and the statewide average of serving all GSAs.

CCTA asserts that in determining the size of the fund, support should be given only to the access lines in need of such support. CCTA recommends that only those GSAs with costs above the statewide average should be eligible to receive monies from the fund.

Citizens commented that a high cost GSA should be defined as any GSA where the cost for providing basic residential service is higher than one standard deviation above the national average loop cost. According to Citizens, the benefits of using such a method are as follows: the criteria is completely neutral because the national average loop cost is a readily available number; it is simple to administer; the numbers can be easily updated; and it can account for changes in the costs of service.

Citizens also recommends that there be a three-year transition period during which the base would move from a direct embedded cost base to the use of TSLRIC as the base. Thus, in the first year, a high cost area would be defined as a specific GSA where the direct embedded cost to provide residential basic service is higher than one standard deviation above the national average loop cost. At the end of the transition period, the high cost area would be a GSA where the TSLRIC cost to provide basic residential service is higher than one standard deviation above the national average loop cost.

In its comments to D.95-07-050, DRA recommended that there be a comparison of costs among the GSAs, rather than comparing cost and revenue as suggested in proposed rule 6.A.6. DRA proposed in its comments that a GSA be considered high cost if the average cost of serving residential customers in that GSA is more than 150% of the weighted statewide average cost of basic service serving residential customers in urban GSAs.[44]

During the hearings, DRA took the position that the reference point should be based on Pacific's existing flat rate service rate of $11.25, plus the EUCL charge of $3.50. The sum of

44 DRA uses the United States Census Bureau definition of urban areas, to define the term urban GSAs.

these two items total to $14.75. The density zone which has the highest TSLRIC, but which does not exceed the $14.75, would then be used as the benchmark zone. The subsidies for a respective zone would then be calculated as the difference between the TSLRIC of the particular zone, and the TSLRIC of the benchmark zone.

According to DRA, the use of its recommended benchmark has two advantages. The first is that it maintains current rates for the vast majority of existing customers because it is based on Pacific's statewide flat rate. Since Pacific has about 80% of the market share in terms of number of lines, the use of Pacific's current flat rate plus EUCL would ensure the maintenance of the same flat and measured rates for most California customers. The second advantage is that it minimizes the size of the fund, while maintaining basic service rates at a reasonable level.

GTEC believes that the universal service fund should be used to prevent rates in a GSA from rising above a level found by the Commission to be affordable. GTEC proposes that the Commission should determine the maximum rate level for basic residential service, and deem that to be the affordable rate. By selecting a statewide affordable rate, the fund is targeted to support rates at affordable levels, rather than to support different rate levels for different companies.

Although GTEC is not proposing that rate rebalancing be done in this proceeding, GTEC believes that rates for basic service which are below this benchmark should be permitted to increase to the benchmark level. According to GTEC, permitting rates to increase to this benchmark will better reflect costs, and reduce the size of the fund. GTEC recommends that the affordable rate be set at $20.00.

GTEC would not use this "affordable" rate benchmark to calculate the support calculation. Instead, GTEC proposes that the COLR serving the high cost area be compensated for the difference between the market rate determined by the proxy cost model, and the rate that the COLR is allowed to charge its customers.

According to the reply briefs filed by the Coalition and TURN, all of the Coalition members, including AT&T, MCI, and TURN, agree that the fund should be sized by first deducting the sum of the incumbent LEC's basic service rate plus the EUCL from the cost of basic service as determined by the model. This results in the gross funding requirement. The second step, as discussed later in this decision, is to deduct the interstate Carrier Common Line Charge (CCLC) revenues, Yellow Pages advertising revenues, and any other revenues from interstate support received by the carrier as offsets. The result of the second step is the net funding requirement.

The United States Department of Defense and All Other Federal Executive Agencies (DOD/FEA) recommend that the Commission establish a rate that would be charged by each provider of residential basic service. DOD/FEA proposes that the rate be based on the average cost of basic service in California's urban areas.

3. **Discussion**

The first issue to decide is whether one or more LEC basic local exchange rates should be used to establish the benchmark, or whether some other reference should be used. The other references that parties have suggested are the national average loop cost, and an average of the statewide proxy costs.

We believe that a benchmark based in part on the national average loop cost should not be used. The national average is not specific to California conditions.

Using a benchmark based on an average of the statewide proxy cost result, however, has some appeal. The statewide average reflects all the CBGs within California, both urban and rural, and mountainous and flat terrain. In theory, this average should more closely reflect the average cost of providing basic service in California than the present rates of the LECs. Using the adjustments that we have adopted, the CPM results in a statewide average cost of $18.39.

If we use the current LEC rates for each of the five LECs subject to today's decision, the rates with the EUCL charge would range from Pacific's charge of $14.75, to Citizens' charge of $21.35.

As we noted in the introduction of this section, and as DRA and TURN have pointed out, the danger with setting the benchmark at too high a level is that it may cause the current rates which are below the benchmark, to rise to the benchmark level. If the statewide adjusted CPM average is used, that could cause Pacific's $11.25 flat rate to increase so as to more closely reflect recovery of its costs. Although the assigned ALJ appropriately barred the issues of overall rate rebalancing and deaveraging from this proceeding, selection of the benchmark will affect other proceedings that seek to address competitive pricing issues.

Another drawback to a high benchmark price is that it reduces the number of areas and households that are eligible for a subsidy. This is not consistent with our universal service goal of trying to increase basic service subscribership to 95%. In addition, reducing the number of GSAs in which subsidies will be available may run counter to the principles regarding affordability that are expressed in the Telco Act and AB 3643. Section 254(b)(1) of the Telco Act provides that "Quality services should be available at just, reasonable, and affordable rates." Section 2(b)(1) of AB 3643 provides that "Essential telecommunications services should be provided at affordable prices to all Californians regardless of linguistic, cultural, ethnic, physical, geographic, or income considerations."

Thus, in developing the benchmark, we must balance the risk of a rate increase, the economic and social burden of subsidizing basic service, and our universal service policies of encouraging subscribership and maintaining rates at affordable levels. All of these considerations lead us to believe that the statewide proxy model weighted average of $18.39 should be used as the benchmark. The use of this benchmark is consistent with promoting the universal service goals of 95% subscribership while maintaining affordable rates, and an adequately sized fund.

The statewide average better reflects the actual costs of providing universal service. The selection of that benchmark also breaks the link with the LECs' current rates. Instead of subsidizing carriers based on existing rates, we are moving toward providing subsidy support based on underlying costs. For those who can choose to live in high cost areas, the cost to serve them will be reflected in their rates, and the subsidy support. This decision, however, does not authorize the incumbent LECs whose current basic service rates fall below the benchmark to increase their rates. Such an exercise should be done by way of an application.

Although the $18.39 benchmark will decrease the number of high cost areas more than a $14.75 benchmark, it provides a targeted and justified level of support to high cost areas. Rates for customers in high cost areas will remain affordable by providing subsidies to carriers willing to undertake the COLR obligation. Affordable prices in high cost areas should result in increased basic service subscribership rates as well.

Accordingly, those GSAs whose adjusted CPM estimate of the cost of providing residential basic service is equal to or greater than the $18.39 benchmark shall be deemed to be high cost areas and eligible for subsidy funding. Those GSAs whose adjusted CPM estimate of the cost of providing residential basic service is less than $18.39, shall be deemed to be low cost areas and not eligible for subsidy funding.

Our adopted rules in Appendix B reflect the above discussion.

The adjusted CPM run reveals that using our adopted benchmark, approximately 3.73 million lines out of approximately 12.7 million total lines, will be subsidized.[45] Due to the lengthy printout that would be required for a run result showing the adjusted CPM estimate of cost for each CBG, and whether a CBG is high cost or low cost, such a table has not been included as part of this decision. Interested parties who desire that breakdown may contact the Telecommunications Division staff to obtain that information.[46] As part of the administration of the CHCF-B, the Telecommunications Division will need to maintain a database of this information, and correlate that information with the service areas of the LECs and CLCs through a mapping or database system.

H. What Offsets Should There Be?

1. Introduction

In D.95-07-050 and D.95-12-021, the Commission described its proposed approach for determining the subsidy amount. In addition to including the tariffed rate for flat or measured rate service as well as the EUCL in the calculation of the subsidy, we stated that other sources of revenues might need to be considered as well. (D.95-07-050, p. 53, fn. 17; D.95-12-021, p. 11.) In the February 21, 1996 ALJ ruling, parties were directed to address the

45 The 3.73 million line figure is after the primary line adjustment. Prior to that adjustment, the number of subsidized lines was 4.52 million lines.

46 Pacific stated in its opening brief that "Pacific intends to run the revisions required by the Commission's decision, then turn that version of the model over to the Commission." Since the CPM has been adopted as the proxy model upon which to estimate the cost of providing universal service, we believe that Pacific's intentions to forward the revised CPM to the Commission is appropriate.

following issue, among others, in their prepared testimony: "Should the Commission consider offsets to the results of the proxy cost model, and if so, what offsets should be considered."

In this proceeding, the parties have debated whether the subsidy should be offset with revenues that the LECs receive from sources such as the federal CCLC, the interstate USF, and revenues from yellow pages. These revenue streams have traditionally been used to keep basic rates low. We discuss below whether these items should be offset against the subsidy.

2. <u>Positions of the Parties</u>

AT&T/MCI point out that the parties generally agree that the revenues received from the current level of residential basic exchange prices, the EUCL, and all payments from the current high cost fund should be deducted from the costs of basic universal service in determining the net funding requirement for the fund. The parties, however, differ as to whether the CCLC, interstate USF funds, and revenues from yellow pages, should be used as an offset. AT&T/MCI contend that the offsets to the subsidy should include federal CCLC revenues, monies from the interstate USF, and LEC yellow pages revenues.

AT&T/MCI assert that the CCLC is a rate element which produces revenues that the incumbent LECs receive to help recover the cost of the loop. Under the split between the interstate and state jurisdictions, 25% of the embedded cost of the loop is allocated to the interstate jurisdiction. Most of the 25% of this cost is recovered in the EUCL charge, and the remainder is recovered in the interstate CCLC. The LECs will continue to receive these revenues to offset the cost of the loop unless the

CCLC is abolished by the FCC.[47]

AT&T/MCI witness Cornell testified that, with the exception of federal Lifeline funding, the interstate USF payments should be subtracted from the needed fund level because the monies are explicitly intended to help support universal service.

AT&T/MCI argue that PU Code Section 728.2, Commission precedent, and the history of yellow pages, are good arguments for using yellow pages as an offset. AT&T/MCI assert that Section 728.2 requires the Commission to consider the net revenues of yellow pages when establishing rates. They contend that the Commission recognized in D.89-10-029 that yellow pages profits should provide a contribution to basic rates. AT&T/MCI note that during the AT&T divestiture the Commission successfully fought to support the regional Bell operating companies' (RBOCs) retention of yellow pages in order to keep basic rates low. AT&T/MCI further argue that the yellow pages business continues to be a monopoly, and that it will not be subject to competition soon because of economic barriers to entry.

CCTA argues that incumbent LECs should offset any high cost subsidy to which they are entitled with the profits from the LECs' yellow pages operations. CCTA claims that this is consistent with Section 728.2 of the PU Code, and Commission policy that yellow pages provides a substantial contribution to basic rates. In addition, it is consistent with the disposition of yellow pages to the RBOCs in the Modification of Final Judgment decision wherein the court stated:

> "When the court required AT&T to turn over its Yellow Pages operations to the operating companies, it assumed that revenue from

47 AT&T/MCI contend that if the CCLC is abolished by the FCC, then all payments received from the federal fund, with the exception of the federal Lifeline fund, should be subtracted from the California fund.

> directory advertising would continue to be included in the rate base of the operating companies, providing a subsidy to local rates." (United States v. Western Electric Co. 592 F.Supp. 846, 865 (D.D.C. 1984).)

CCTA cautions that if the incumbent LECs' revenues from yellow pages are not offset against the fund, the Commission will allow the LECs to double recover these profits.

CCTA also argues that contrary to the assertions of GTEC and Pacific, the yellow pages market remains non-competitive and will continue to be dominated by the LECs because of their immediate direct access to all subscriber information.

CCTA recommends that because the testimony of AT&T witness Patricia vanMidde suggests that the yellow pages profits for Pacific and GTEC are $495 million and $49.5 million, respectively, the Commission should set a minimum yellow pages offset level of $500 million for Pacific, and $50 million for GTEC.

The Coalition contends that the revenues from yellow pages constitute an explicit and sustainable source of universal service support, and should be used to offset the amount of the fund. The Coalition points out that yellow pages profits have historically been, and continue to be designated as a source of funds to support universal service.

DCA argues that yellow pages revenues should not be included as an offset to the new high cost fund because this would amount to continuing an implicit subsidy. DCA also contends that the yellow pages market is not a natural monopoly and is likely to become increasingly competitive.

DRA takes the position that the subsidy for high cost areas should be offset by revenues from the following federal sources, the EUCL, the USF, and CCLC. DRA asserts that these offsets are necessary in order to avoid double recovery of costs by the COLRs.

With respect to revenues from yellow pages, DRA is opposed to using those revenues as a direct offset to the fund. DRA instead favors calculating the subsidy based on the TSLRIC cost of basic service, and pricing the LEC's basic network functions (BNFs) in OANAD at TSLRIC. Therefore, DRA believes that the revenues from yellow pages should be used by the LECs to provide a source of recovery for the LEC's shared and common costs that the BNFs would not otherwise be able to recover. DRA is also of the opinion that using revenues from yellow pages as an offset would result in the LECs continuing to rely on yellow pages as an implicit subsidy. DRA asserts that this would be contrary to the Commission's goal of making the subsidy for universal service explicit.

DRA states that the USF is an FCC charge to keep basic service rates affordable for high cost companies, and is currently only available to the LECs. As a result of the Telco Act, the USF is expected to be extended to non-LECs as well.

GTEC argues that no offsets should be considered. GTEC maintains that these mechanisms, such as the CCLC and revenues from yellow pages are implicit subsidies which have been used in the past to support universal service. By developing a new and explicit, and competitively neutral funding mechanism to replace the implicit subsidies, GTEC does not believe that the implicit subsidies should be reintroduced as a proposed offset.

With respect to the CCLC, GTEC asserts that the revenues from the CCLC should not be considered in calculating the fund. GTEC points out that the local exchange customer does not pay the CCLC as a result of ordering basic exchange service. Instead, it is only when the customer chooses to use interstate long distance calling that CCLC revenue will be generated. Thus, customers with little or no access demand will generate little, if any, revenue for the COLR that serves them. If an average amount of CCLC revenue is used as an offset to calculate support, but the LEC loses some of its high volume interstate callers, the COLR will lose those revenues that such an offset would include. GTEC also points out that the FCC has sought comment on the use of a combination of EUCL increases and universal service funding to reduce the CCLC.

GTEC also asserts that there is no risk of double recovery as a result of not including CCLC revenues as an offset. GTEC contends that the total investment estimated by the forward looking CPM for GTEC reflects only 46% of GTEC embedded loop cost.

GTEC argues that yellow pages revenues should not be used as an offset for several reasons. The first is that yellow pages revenue come from an unrelated, non-telecommunications business. Yellow pages advertising is not generated by residential basic service subscribers, but instead by business customers. Second, the inputs required to enter the directory assistance business are available to any publisher, and are not tied to the assumption of any COLR responsibilities. New entrants are not required to develop directory publishing as a condition of entry into the market. Third, revenues from yellow pages differ among the carriers, which would need to be taken into consideration if such an offset was used. And fourth, PU Code § 728.2 provides that yellow pages revenues and expenses may be considered in setting rates for other services offered by telephone corporations. GTEC asserts that this does not mean it should be considered for calculating the size of the universal service fund.

GTEC also asserts that although revenues from yellow pages have been used in the past to support universal service, using such revenues as an offset is inconsistent with the Telco Act that any universal service support should be made explicit. Finally, GTEC maintains that using yellow page revenues as an offset violates Section 728.2 of the PU Code which permits the Commission to consider yellow pages revenues when setting rates, not for sizing a universal service fund.

Pacific believes that EUCL should be included in determining revenues for the high cost fund, but that the CCLC, and yellow pages revenues should not be included. Pacific also believes that any new universal funding the FCC establishes in implementing the Telco Act should also be considered in determining revenues for the high cost fund.

Pacific's witness Mitchell noted that the CCLC is currently assessed on interstate switched access charges on a per minute of use basis. Since it is billed in this way, instead of being directly charged to the end user, it will distort the competitive landscape if the CCLC is considered as an offset. Pacific has recommended to the FCC that the CCLC should be eliminated. As for DRA's double recovery argument, Pacific contends that since its current prices were set with reference to state separated costs, and since Pacific will reduce prices for every dollar it receives form the fund, there will be no double recovery.

Pacific argues that the proposal to include revenues from yellow pages as an offset would violate Section 728.2 of the PU Code. Pacific contends that Section 728.2 allows the Commission to take yellow pages revenue into account when setting rates for services, not when establishing surcharge amounts for a fund.

Pacific also contends that such a proposal results in an unconstitutional taking of property, and that using the revenues as an offset would destroy the value of the LECs' yellow pages operations. Under AT&T/MCI's proposal, all the margin from the yellow pages operations would be used to pay for universal service funding. In an extreme case, a LEC could find itself turning over its yellow pages profits even though it doesn't qualify for any subsidies itself. This would eliminate any indirect return to the LECs from their yellow pages business.

Pacific also contends that a yellow pages offset eliminates another source of recovery for shared and common costs.

In addition, the offset would reduce or eliminate the other carriers' obligations to contribute to the fund. Also, the revenues from yellow pages is unlikely to be sustainable over the long term.

The Small LECs contend that the proposals to use interstate USF and access pool revenues to offset intrastate costs is inconsistent with the jurisdictional separations responsiblities of the federal and state governments. They contend that interstate support revenues are intended to support interstate costs, and not intrastate costs.

TURN believes that the yellow page offset is "one of the most important steps that the Commission must take in this proceeding." (TURN, Reply Brief, pp. 30-31.) TURN contends that an offset of yellow pages revenue is necessary in order to ensure that carriers are not over compensated for serving high cost areas. TURN argues that yellow pages profits have historically been used to support basic exchange service and that local telephone competition will not alter the long term sustainability of those profits.

3. **Discussion**

There is no disagreement that revenues from basic service should be included as an offset. Therefore, revenues should be offset against the fund.

We agree with the parties that the EUCL charge should be considered as an offset to the fund. It is an appropriate offset because it recovers a large share of the interstate portion of the LECs' NTS embedded loop costs. In addition, the CPM benchmark does not recognize the receipt of these monies when it calculates the cost of providing universal service on a statewide basis. The residential and single line business EUCL charge is capped at $3.50.

As for the CCLC, we agree with AT&T/MCI, DRA, and TURN that the CCLC should be used as an offset. The LECs' argument that the CCLC is a switched access, usage-based rate is irrelevant. What is relevant is that the CCLC recovers the remaining portion of residential and single line business interstate NTS costs that are not recovered by the EUCL charge. To ignore recovery of this amount by the LECs would overcompensate them for the loop.

As for the monies that the five large and mid-size LECs may receive from the interstate USF, we agree that those monies should be used as an offset. However, only a portion of interstate USF funding should be considered since the USF is designed to cover the entire cost of a company, not just the cost of serving residential customers or customers in high cost areas. Therefore, the fund should only be offset by the carrier's per line monthly USF draw multiplied by the percentage of lines eligible for high cost assistance in California.

With regard to the CHCF-A, GTEC and Pacific are ineligible for this fund. The three mid-size LECs are currently ineligible or are transitioning away from this fund as a source of universal support. Accordingly, no offset is required for monies from the CHCF-A.

With regard to the revenues from yellow pages, we conclude that those revenues should not be included as an offset. As we noted in D.95-12-021, PU Code § 728.2(a) suggests that the revenues and expenses associated with yellow pages should only be considered when establishing <u>rates</u> for other services. (D.95-12-021, pp. 11-12.) We are not establishing rates for other services in this proceeding. All that we are doing is establishing a fund to subsidize high cost areas of the state. In addition, the use of revenues from yellow pages would significantly reduce the contribution of others to support the fund. Such a result is contrary to the expressed intent in the Telco Act and AB 3643 that there be "equitable" support. For those reasons, we decline to include revenues from yellow pages as an offset.